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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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The majority of subscribers to this Service have tried other methods; many follow these Letters along with one or more different services in the field. Some subscriptions arrive here out of curiosity, others in the belief that this writer possesses some "magic" formula for forecasting the trend of the market, while still others are sent through sheer desperation or a process of careful elimination. The curious and the desperate often become excellent students of the market, but those who seek the magic solution are doomed to disappointment and will lose both their patience and their capital in the end.

Yet a gratifying number of letters arrive here each week from subscribers who realize that the price movements, as measured by the D-J industrial and rail averages taken together with volume, provide us not only with the best barometer of future economic expansions and contractions, but also with our best indicator of future stock trends. These subscribers are serious students of the market. They are also aware, however, of the limitations inherent in any market system.

There is a simple logic behind the seemingly mysterious ability of the averages to predict. When a corporate officer senses something which may affect his company, he will protect himself by buying or selling stock depending upon whether the forthcoming news is bullish or bearish. Each investor tends to be a specialist in his own field, and the combined intelligence and action of all investors appears as a pattern in the price movements. These patterns provide indications well ahead of any statistical evidence which may eventually come to the attention of the analysts and economists.

BONDS. The bond average has never been a factor in forecasting market trends under Dow Theory. In general, bonds tend to fluctuate inversely with the money rates. But since a good many readers hold debt securities, a few words about bonds may be in order. There is much to substantiate the theory that interest rates (and therefore bond prices) move in extended cycles of twenty years or so. From the lows of 1900, interest rates rose to a peak around 1920, then headed down to another low in 1946. Since 1946 the trend has been to progressively higher interest rates. In other words bonds were in a bull market from 1920 to 1946; they have been in a bear market since the 1946 highs. Based on the interest rate cycle, it appears that the present bear market in bonds will culminate around 1966-70.

The 1929-32 stock market collapse carried most debt securities with it despite the fact that bonds were then in a long-term bull market. The average yield on all corporate bonds rose from 4 3/4% in 1929 to 8% in 1932 with a corresponding drop in bond prices. The 1937-8 bear market had much the same effect but on a milder scale. In contrast to the 1920's and '30's, however, the long-term trend of bonds is now down. Should a bear market appear in the next few years it would put the bondholder in double jeopardy. In this case we might see some spectacularly low prices in an already depressed group.

UTILITIES. A popular fallacy has it that utilities, like bonds, move with the money rates. But a study of the utility price movements will show that they actually move with the primary trend of the market. One also hears that utilities (which tend to stay in the hands of informed investors) top out before the general market. Informed investors, it is reasoned, do their distributing early, and this causes the utility average to turn down before industrials and rails.

In 1929 and 1946 the utility average topped out with the general market, but 1937 saw utilities turn down a few months before the other two averages. In every case since 1932 utilities hit their bear market bottoms at about the same time as industrials and rails. Therefore we may infer that utilities top out with or a little before the general market, and they hit bottom at about the same time as the general market.

Starting from a low of 33.36 in 1949, utilities recently hit a bull market high of 94.70 in March of 1959. This was their highest level since the 1930 highs of 108.62 (the 1929 high was 144.61). But since the recent highs, utilities have headed steadily down causing many observers to suspect that they have topped out.

Because of their large debt structures and relatively stable dividend payouts, utilities are now being affected by rising money rates. Although I am not intrigued with the utilities as a group, I believe that they are still subject to the force of the primary trend. If this is true, we may say that the utility group should not collapse (as have bonds) until the bull market nears its final top. If the primary trend continues up the chances are that utilities will hold or advance above their 94.70 high. The ability of the D-J utility average to stay above its recent 85.71 low will provide a clue as to whether this group has seen its low prices for the year or not.

THE MARKET. Letter 69 pointed out the probability of a "buy-spot" in the averages. Traders who bought stock last week will wear smiles if and when the two averages better their previous highs at W (see chart - industrials 643.79, rails 169.67).

Rhea identified a buy-spot in this way: following a decline or a reaction, an advance will take both averages some distance towards the old highs. Subsequent to the advance, if on the next decline one or both averages hold above their previous lows and volume diminishes as those lows are approached, then stocks may be purchased. Rhea also noted that buy-spots were "...those places where stocks may be purchased with reasonable expectation of gain, and abandoned with but negligible losses if the signals are reversed."

On the decline from pt. Y, volume dropped to its lowest ebb in many months. Because of this low volume I wrote in Letter 69 that the "liquidation could well be over". If the two averages now hold above the X pts. (industrials 617.63, rails 160.46) we may expect an eventual rally through the highs as well as some profits on recent purchases. If the X pts. are violated on increasing volume we will have to say that the "signals are reversed". In the latter event, our new purchases may be sold with small losses. The breaking of the X lows on increasing volume would be a very bearish indication, at least for the near term, and trading commitments sold on such a violation would have to be written off as "insurance" against the possibility of a severe reaction.

I might reiterate that the validity of buy-spots grows increasingly weaker as the market advances. The best buy-spot invariably occurs on the first dip following a secondary reaction. Such a spot appeared on November 14, 1957, eight points from the 419.79 industrial low. Obviously a buy-spot which now appears 20 months later and 200 points higher cannot be expected to be as safe or as profitable. Investors who have missed the entire swing since the '57 lows will still do better if they make their purchases on the implications of the averages rather than on the basis of friendly "tips" or optimistic newspaper articles. If the market were really susceptible to bullish advertisements, pronouncements and tips, the D-J industrials, starting at 588 in January, 1959, would now be 1000.

The action of the market since Letter 69 has been cautiously bullish. Although volume has been dull on the advance from the X lows, a definite upward zig-zag (pts. X-Y-Z-A) has formed in both averages. Such a formation usually holds bullish connotations. It now remains to be seen whether enough steam can be generated under the market boiler to advance both averages above their previous highs at W. It would not be unusual for a "line" to develop here, and if this occurs there should be ample time to discuss it in our next Letter. An upward extension of the zig-zag on increasing volume would be bullish, particularly if volume expands on rises and contracts on dips. An approach to but not

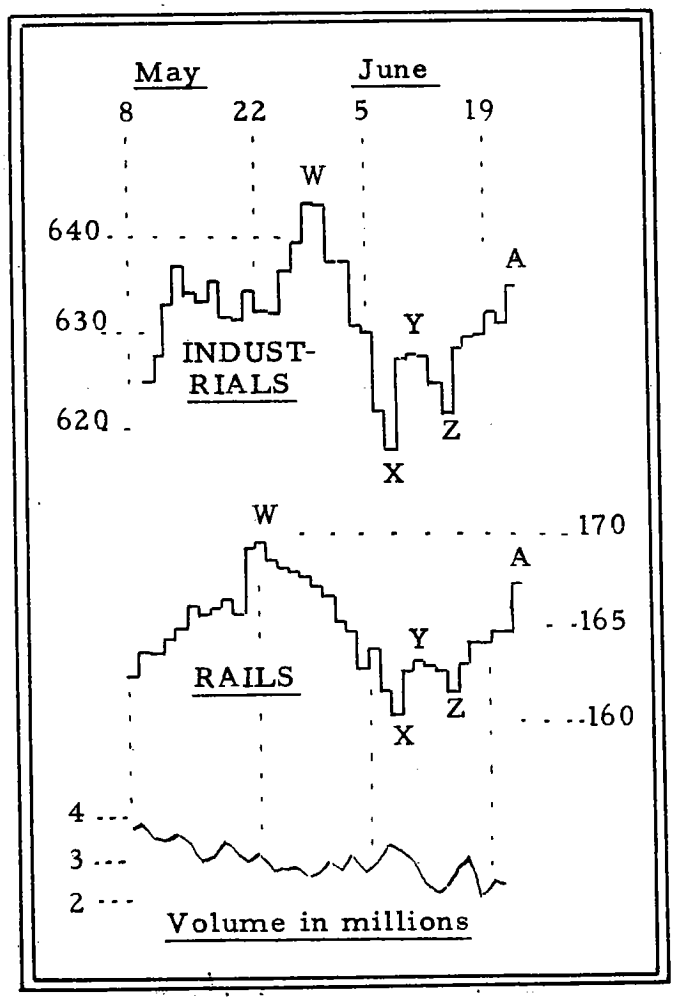
over the W highs followed by a decline on expanding volume would, of course, be a danger signal, but the X lows provide a good check point on the downside, and recent acquisitions should not be discarded unless the X lows are broken by both averages on increasing volume.

STOCKS. The following stocks have good technical patterns and might be purchased with "buy-spot" implications in mind: HEYDEN NEWPORT, W. R. GRACE, BUCYRUS-ERIE, JOY MANUFACTURING, NATIONAL ACME, WARNER & SWASEY. Here are two low-priced numbers which might be picked up on a strictly speculative basis: LEHIGH VALLEY INDUSTRIES, GRAHAM-PAIGE CONVERTIBLE PREFERRED.

This might be a good place to comment about buying individual stocks on the basis of spot news. Texaco spurted on the recent merger report although the technical pattern of the stock was poor. Those who bought it are already showing losses and there is a good chance that these losses will increase. American Cyanimide also jumped on the publication of news concerning an oral anti-polio drug. But Cyanimide dropped the next day, and the stock was and still is a sale if it hits 52. Most good issues are carefully accumulated weeks or months before the good news is released. Weak stocks may rally on spot news, but unless something has occurred which radically changes the outlook for the company they will shortly fall back into their old patterns.

Along these lines, if a stock is under distribution, insiders will leap at a chance to unload it under the disguise of temporary bullish news. Many oils and aircrafts, for instance, have been distributed on every rally or hopeful report since late 1958. How do we know this? Simply because on the rallies they could not better previous resistance levels and on declines they violated important supports.

(Written June 24, 1959, after the close of the market)



Thirty Stocks Used in Dow Jones Industrial Averages are:

Allied Chemical	General Electric	Sears Roebuck
Aluminum Co.	General Foods	Std Oil of Cal.
Amer Can	General Motors	St. Oil of N. J.
Amer Tel & Tel	Goodyear	Swift & Co.
Am Tobacco	Inter Harvester	Texaco Inc.
Anaconda Co.	Inter Nickel	Union Carbide
Bethlehem Steel	Inter Paper	United Aircraft
Chrysler	Johns Manville	U. S. Steel
Du Pont	Owens-Ill. Glass	Westinghouse El
Eastman Kodak	Procter & Gamble	Woolworth

Twenty Railroad Stocks Used are:

Atchison	Erie	NY NH & H
Atl Coast Line	Great North Ry	Norfolk & West'n
Baltimore & Ohio	Illinois Central	Pennsylvania
Canadian Pacific	Kansas City So	Southern Pacific
Ches & Ohio	Louisv & Nash	Southern Railway
Chi Rk Is & Pac	N. Y. Central	Union Pacific
Del & Hudson	N. Y. C. & St. L.	